PERSONAL FINANCE

What Is Peer-to-Peer Lending?

Reading Time: 4 minutes

Highlights:

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- Peer-to-peer (P2P) lending allows borrowers to apply for loans from individual investors instead of banks or other financial institutions.
- P2P lending takes place through specialized websites that connect individual lenders with borrowers who are looking for a loan.
- All loans involve some level of risk. However, because P2P loans don't have the protection of a bank, or other established financial institution, there are a few extra drawbacks to keep in mind.

Peer-to-peer (P2P) lending is a way for people to borrow and loan money without involving a bank or other financial institution. Have money to lend and looking for an investment opportunity? Trying to finance a large purchase with a loan? P2P lending may be an option for you.

What is P2P lending?

Also known as social or crowd lending, P2P lending allows borrowers to apply for loans from individual investors instead of banks or other financial institutions. Borrowers apply using specialized lending websites that connect them to potential investors.

As a borrower, P2P lending might be attractive for multiple reasons. First, P2P loans tend to have lower eligibility requirements compared to loans from a bank. If you are struggling with your credit scores and cannot qualify for a traditional loan, you might have more success with a P2P loan. Also, P2P loans tend to have flexible repayment terms, along with potentially competitive interest rates.

As a lender, P2P loans offer a unique and potentially profitable investment opportunity. Like traditional loans, P2P lenders charge interest on the money they loan. The size of the lender's profit depends on several factors including the amount they lend, the P2P platform they use and whether the borrower can pay back what they owe.

How does P2P lending work?

P2P lending takes place through specialized websites that connect individual lenders with borrowers who are looking for a loan. Rules and practices vary from platform to platform, but P2P lending generally works as follows:

For Borrowers

Borrowers first find a P2P platform that meets their particular needs and interests. Different platforms usually have specific niches, such as small business loans or personal loans to cover things like medical expenses or home improvements. After finding a P2P platform match, borrowers submit an application. The review process varies by provider, but it generally involves both the P2P platform and potential lenders assessing your financial information. Like other loan applications, this process may trigger a hard inquiry on your credit reports.

Once the application review is complete, the borrower is generally able to see what interest rate they will receive for their loan. Potential investors will then decide whether they are willing to fund the loan and may even negotiate with the borrower to change certain terms. Once the borrower is matched with an investor, the payout and repayment process starts.

For Lenders

When getting started with P2P lending, investors find a compatible site where they deposit money into an investment account that will be used to fund future loans.

Once a loan is made and the loan term ends, the investor usually makes a profit because the money they spent has been paid back with interest. However, if the borrower repays the loan quickly, the initial investment has less time to accumulate interest, so the investor makes less money.

Investors can choose to spread their funds among different borrowers to diversify their investments and lower their risk. However, investors still deal with uncertainties, as borrowers who use P2P lending are more likely to default on their loans than those who pursue traditional methods of borrowing.

Is P2P lending safe?

All loans involve some level of risk. However, because P2P loans don't have the protection of a bank or other established financial institution, there are a few extra drawbacks to keep in mind.

Unlike traditional banks, individual investors assume all of the risk when providing P2P loans to borrowers. These loans are usually unsecured, meaning if the borrower can't pay back what they owe plus interest, the investor loses their money.

If the borrower defaults, the P2P platform may raise the interest rate, assess fees or send the loan to a collection agency in as little as 30 days. Traditional banks tend to provide more resources for borrowers who are struggling, so understanding the differences when using P2P lenders is vital.

Pros and cons of P2P lending

Here are a few other benefits and drawbacks of P2P lending:

Pros

- **Faster process compared to traditional loans.** Because P2P platforms are online, the loans are normally approved by automated systems, meaning the entire process could take as little as a few days.
- **Lower eligibility requirements.** Borrowers may find it easier to qualify for a P2P loan compared to working with a traditional bank. If you don't have a credit history or are working on improving your credit scores, P2P lending might be a better option.
- **Flexible repayment terms.** P2P lending platforms don't have to abide by strict regulations, so borrowers have more options when it's time to repay.

Cons

- **Higher interest rates.** People with lower credit scores may get higher interest rates than they would with a traditional lender.
- **Service/maintenance fees.** Borrowers may be charged additional fees beyond their interest payments.
- **Less guidance when repaying your loan.** Since the entire process is online, it may be difficult to develop a relationship with the P2P platform. Also, traditional banks tend to provide resources for managing your debt and creating a repayment plan, while P2P platforms do not.
- **Higher risk for investors.** With P2P lending, the direct connection between lenders and borrowers means the investor takes on all the risk and they will likely lose money if the borrower defaults on the loan.

When considering P2P lending, be sure to understand the pros and cons before moving forward with an application. While P2P loans can be a good option for both investors and borrowers, they still carry some risk.

Before applying for a P2P loan, or any other new line of credit, it's a good idea to check your credit reports and credit scores.

Sign up for a credit monitoring & ID theft protection product today!

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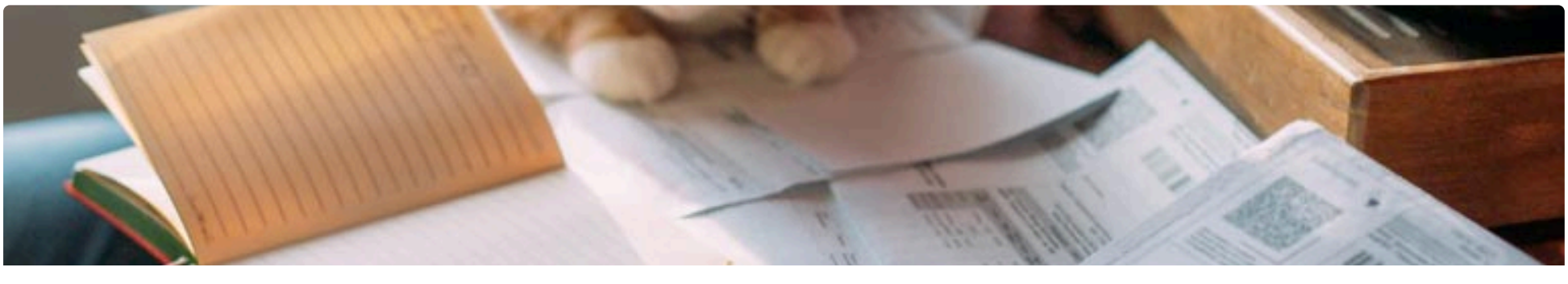

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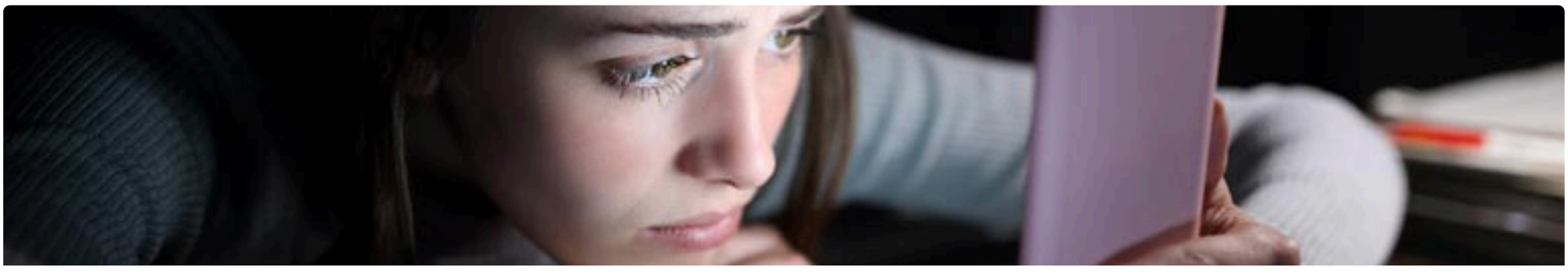

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